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BEFORE THE

Federal Communications Commission

WASHINGTON, D.C. 20554

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JAN 27 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of	)	
	)	
Implementation of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket No. 92-266
	)	
Rate Regulation	)	

To: The Commission

COMMENTS OF MUZAK LIMITED PARTNERSHIP

MUZAK LIMITED PARTNERSHIP

By: Edward W. Hummers, Jr.
Paul J. Feldman

Its Attorneys

Current address
FLETCHER, HEALD, & HILDRETH
1225 Connecticut Ave. N.W.
Washington, D.C. 20036
(202) 828-5700

Address effective February 1, 1993

Fletcher, Heald & Hildreth
11th Floor
1300 North 17th Street
Rosslyn, VA 22209
(703) 812-0400

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SUMMARY

One of the major purposes underlying the Cable Television Consumer Protection and Competition Act of 1992 (the "1992 Cable Act" or the "Act") was Congress' intent to protect consumers from unreasonable rates that have been charged by many cable operators since the deregulation of rates resulting from the 1984 Cable Act. In these Comments, Muzak demonstrates that cable television rate regulations must address and prevent the cross-subsidization of unregulated cable audio services by subscribers to regulated residential cable video services, in order to protect those residential subscribers from paying unreasonable rates.

The Commission proposes numerous methods for regulating the rates for basic services. However, Section 623(b)(2)(C)(iii) of the Communications Act, as recently amended, <u>requires</u> the Commission to take ensure, in establishing a rate regulations, that only that portion of joint and common costs properly allocable to basic service is charged to basic rates. The Commission <u>must</u> enact rules which require the proper allocation of joint costs, and of the regulatory alternatives suggested in the <u>Notice</u>, only the "typical cost-of-service" benchmark approach, and the two suggested individual system cost-based alternatives, seem to address the proper allocation of joint costs. Accordingly, the Commission must enact one of those regulatory models. Furthermore, legislative history demonstrates Congress' intent that the Commission use a "fully allocated" cost model.

Lastly, while Muzak believes that use of some the regulatory methods discussed above may help ensure that reasonable rates are

offered to subscribers, it is concerned none of these methods will be sufficient to prevent cross-subsidization between regulated and non-regulated services without an additional requirement that cable systems establish a separate subsidiary, with separate books, to operate non-regulated services.

In establishing its rate regulation methodology, the Commission must remain cognizant of the changes occurring in the cable services business, including the actual and intended growth in the provision of "non-traditional" audio, video and data services by cable operators. In is incumbent on the Commission to now establish a rate regulation system that will account for the impact of these new services on rates charged for regulated services.

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Muzak Limited Partnership ("Muzak"), by its attorneys, hereby files it comments in response to the Notice of Proposed Rule Making, released December 24, 1992, in the above-captioned proceeding (the "Notice").

Muzak, which was founded in 1934, produces and delivers music services to approximately 200,000 subscribers, primarily businesses, throughout the United States. The provision of music services to businesses, alone or in conjunction with other audio information, video and data transmission services[1], is currently growing at a substantial rate, and competition to provide such services will continue to grow along with the size of that market. In these Comments, Muzak demonstrates that cable television rate

[1] While the provision of music services is Muzak's "core" business, it also offers one-way transmission of other business audio programming, such as in-store advertising, one-way data transmission, and private video conferencing services.

regulations must address and prevent the cross-subsidation of unregulated cable audio services by regulated residential cable video services in order to protect residential subscribers from paying unreasonable rates.

I. **The Cross-Subsidization of Unregulated Audio Cable Services By Regulated Video Cable Services**

One of the major purposes underlying the Cable Television Consumer Protection and Competition Act of 1992 (the "1992 Cable Act" or the "Act") was Congress' intent to protect consumers from unreasonable rates that have been charged by many cable operators since the deregulation of rates resulting from the 1984 Cable Act[2]. Section 3 of the Act amends Section 623 of the Communications Act to require the Commission to establish methods for regulating the rates charged for basic and enhanced cable services where a cable system is not subject to "effective competition." In light of the importance Congress placed on protecting consumers from unreasonable rates, Section 3 is one of the most important sections of the Act, and its requirements must be fully enacted if Congress' goal is to be achieved.

While the focus in the Act is generally on video cable services, cable operators also presently provide audio programming services. Such services include programming (e.g., "Digital Music

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[2] See Sections 2(a)(1), 2(a)(2), 2(b)(4) and 2(b)(5) of the Act; See also House Committee on Energy and Commerce, H.R. Rep. No. 102-628, 102d Cong., 2d Sess. at 26 (hereinafter, the "House Report"):

> H.R. 4850 is designed to address the principal concerns about the performance of the cable industry and the development of the market for video programming since passage of the [1984] Cable Act. This legislation will protect consumers by preventing unreasonable rates ....

Express" and "Digital Cable Radio"[3]) offered to residential subscribers, as well as programming offered to businesses and designed to compete with programming offered by Muzak. It is well known that cable is actively pursuing the institution of non-traditional audio, video and data services. Congress may not have contemplated the application of rate regulation to cable audio and other non-traditional services: such services do not clearly fit into the definition of "cable programming services" as defined in the 1992 Cable Act and codified in Sections 623(l)(2) of the Communications Act, nor do they seem to be contemplated as components of the "basic" services subject to rate regulation, as codified in Section 623(b)(7) of the Communications Act. However, even if audio and other services are themselves unregulated under the Act, the operation of such services creates expenses which, if not properly allocated, could be improperly shifted to regulated services and paid for by subscribers of regulated services, even if those subscribers do not receive the audio and other services. Such a result is clearly contrary to Congress' goal of ensuring that rates for cable video services are "reasonable."[4]

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[3] Both Digital Cable Radio and International Cablecasting Technologies, Digital Music Express' corporate parent, are owned in part by major cable television MSOs.

[4] The Commission has long recognized that cross-subsidation of unregulated services leads to unreasonable rates for subscribers of regulated services. See, e.g., Telephone Company-Cable Television Cross Ownership Rules, Further Notice of Inquiry, 3 FCC Rcd 5849, 5859 (1988):

> Finally, we have established in the Joint Cost proceeding a system of accounting designed to prevent carriers from imposing costs and risks of nonregulated activities on ratepayers for regulated services. This accounting system protects ratepayers from unjust and unreasonable interstate rates that could otherwise result from cross-subsidation, misallocation of joint and common costs and

Unfortunately, Muzak has often seen, in markets throughout the country, cable operators offer audio services to businesses at rates so dramatically low as to suggest that these services were being offered at or below cost. This abusive tactic is designed to undercut services offered by, and eliminate competition from, non-cable system providers. Regardless of the impact on competition, however, it is obvious that cable operators must recover the costs of unregulated services from somewhere, and the obvious source is from subscribers to regulated services. Costs of unregulated services are allocated to regulated services, and as a result, residential subscribers to regulated cable video services end up paying for the costs of unregulated business audio services. This abuse will be exacerbated as cable expands its non-traditional services. This result is clearly contrary to the Act's goal of preventing unreasonable rates to consumers, and must be addressed in this proceeding if the Commission is to fulfill the regulatory mandate established in the Act.

II. The Regulation of Basic Services

Section 3 of the Act amended Section 623 of the Communications Act to require the Commission to enact regulations to ensure that rates paid for basic service are reasonable. The Notice (para. 33) identifies two generic approaches for regulation of basic service rates: "benchmarking" and traditional cost-based regulation. While the Notice reviews a number of alternatives within each regulatory approach, it tentatively concludes that due to the complexity and expense associated with cost-based regulation, it should select the benchmarking approach, although cost-of-service principles could

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improper intracorporate transfer pricing.

have a secondary role for operators seeking to justify the reasonableness of rates that exceed benchmark standards. Notice at para. 33. Before discussing the alternatives set out in the Notice, it must be noted that the Commission's tentative decision to generally ignore cost-based methods is clearly contrary to the requirements established in the Act. In establishing the structure of the regulations the Commission must enact to meet the goal of ensuring reasonable basic rates, Section 623(b)(2)(C) provides that the Commission:

> shall take into account the following factors:
>
> > ...
> >
> > (iii) only such portion of the joint and common costs (if any) of obtaining, transmitting, and otherwise providing such signals as is determined, in accordance with regulations prescribed by the Commission, to be reasonably and properly allocable to the basic service tier, and changes in such costs;

(emphasis added).

As the D.C. Circuit has recently stated, "'[s]hall'is the language of command."[5] The Act does not give the Commission the discretion to ignore cost allocation principles in enacting rate regulations, regardless of the Commission's preference, as a matter of policy, for simpler regulatory structures.[6] And while Section 623(b)(2)(A)

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[5] AT&T v. FCC, No. 92-1053, slip at 15, (November 13, 1992) (quoting MCI Telecommunications Corp. v. FCC, 765 F.2d 1186 (D.C. Cir. 1985)).

[6] In a manner strikingly similar to the Commission's tentative decision in this proceeding, the Commission previously concluded that the costs of requiring "non-dominant" carriers to file tariffs outweighed the resulting benefits to consumers, and thus decided to forebear from enforcing against such carriers the requirement set out in Section 203 of the Communications Act that every common carrier "shall" file tariffs. Competitive Carriers, Fourth Report and Order, 95 FCC 2d 554, 557 (1983). In reversing this decision, the D.C. Circuit not only stated that "shall" is a

states that the Commission should "seek" to reduce the administrative burden on cable operators and regulatory authorities, there is no necessary conflict between this provision and that in Section 623(b)(2)(C) requiring the Commission to choose one principle over the other. Accordingly, the Commission _must_ enact rules which require the proper allocation of joint costs, and the "search" to reduce administrative burdens must come _within_ the context of enacting such regulations. Of the regulatory alternatives suggested in the _Notice_, only the "typical cost-of-service" benchmark approach, and the two suggested individual system cost-based alternatives, seem to address the proper allocation of joint costs. Accordingly, the Commission must enact one of those regulatory models.

A. _Benchmarking Approaches_

The _Notice_ describes a benchmark rate as a price against which a given cable system's basic tier rate would be compared. The system's rate for basic service would be presumed to be reasonable if it did not exceed the benchmark, and systems with higher rates would have to reduce them or justify the difference. _Notice_ at para. 34. The following benchmark alternatives are proposed:

1. Rates charged by systems facing effective competition;
2. Rates charged prior to effective deregulation of rates pursuant to the 1984 Cable Act;
3. An average per-channel rate for basic service channels charged by all cable systems;

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command, it held that the Commission cannot use policy decisions, even if they are rational, to circumvent the regulatory requirements established by Congress. _AT&T v. FCC_, _supra_ note 3, at 17.

4. Cost-of-service of an "ideal" or "typical" system.

As was noted above, the Commission must enact regulations that take into account the portion of joint and common costs properly allocable to basic service. The first three benchmarking alternatives described by the Commission focus almost solely on rates and ignore the required factor of properly allocating joint costs.[7] Accordingly, these three proposals must be rejected on that basis alone. Furthermore, in light of the evidence that some cable operators cross-subsidize audio services with video programming revenues, any benchmark based on existing or previous rates would only institutionalize this cross-subsidization, and would not address the harm suffered by video programming subscribers of higher rates due in part to their subsidizing audio services.

Accordingly, if the Commission is to use a benchmark approach, it should use the "typical" cost-of-service benchmark (para. 48). However, in order to meet the requirements of Section 623(b)(2)(C), this approach must take into account the proper allocation of joint

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[7] In a general analysis of the benchmarking approach the Notice (para. 36) states that benchmark formulas would "eliminat[e] the need for detailed cost-based regulation...." The use of the Consumer Price Index to analyze changes in the "cost of doing business" (para. 38) as a factor in adjusting benchmarks does not address the matters at issue here. And while "readily identifiable costs" are a factor proposed to separate cable systems into distinct classes with different benchmark rates (para. 37), there is no discussion of allocation of costs, or of use of cost-analysis to prevent cross-subsidation. Similarly, in its specific analysis of the "effective competition" benchmark formula (para. 43), while the Commission asks whether the benchmark should be adjusted to reflect the "costs of systems subject to it," there clearly is no plan to analyze the proper allocation of costs or to prevent cross-subsidation. Lastly, the proposal to permit upward adjustments to the "average rates" benchmark formula based on rebuild costs (para. 44) does not even address the matters at issue here.

and common costs. While there may be some difficulties in calculating "typical" costs-of-service, as the Commission notes, there is precedent for similar approaches in common carrier regulation. Notice at page 34, note 88.

B. Individual System Cost-Based Alternatives

As noted above, Section 623(b)(2)(C) requires the Commission to take into account the proper allocation of costs attributable to basic services in regulations designed to ensure reasonable rates for subscribers. Because costs will obviously vary from system to system, the most effective manner of fulfilling this requirement and ensuring reasonable rates is through use of cost-based regulatory structures that analyze the facts regarding individual systems.

One individual system cost-based alternative proposed by the Commission is use of cost-of-service ("COS") regulation traditionally applied to public utilities. Notice at para. 57. Noting the "rigorous" cost accounting requirements of this approach, which significantly depart from current cable industry practice, as well as the substantial burdens of this sort of regulation on operators and regulators, the Commission concludes that COS regulation should not be the primary method[8] of regulating rates for basic service if the record in this proceeding will support use of a benchmark alternative. Notice at para. 59.

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[8] The Commission suggests that it would consider permitting cable systems to use a COS approach to justify rates higher than the "benchmark" applicable to their system. Notice at para. 59. Even if this use of COS regulation included proper allocation of joint and common costs, use of the COS method as a secondary method only when the operator's rates are higher than the benchmark fails to meet the requirement in the Act that rate regulation must take into account the proper allocation of joint and common costs.

The Commission provides no support for its tentative conclusion that the cost of COS regulation outweighs any benefits. First, the Commission itself describes its proposed cost-accounting requirements as "simplified," in comparison with those traditionally used. Notice at para. 57. Clearly the administrative burden on both operators and administrators will be substantially reduced through use of these "simplified" requirements. Indeed, the Notice states (at note 84) that its proposed accounting requirements are based on Generally Accepted Accounting Principles, and "should be simple for cable systems to use and regulatory authorities to administer." Second, the Notice glosses over the potential advantages of COS regulation with one sentence noting that such regulation can prevent operators from "extracting monopoly rents from consumers." Notice at para. 58. This is precisely the intent behind the rate regulation provisions of the Act, and thus is a benefit that should not be readily dismissed. Thus, the balance of benefits and burdens resulting from COS regulation must be substantially reviewed before this method is rejected.

The Commission describes its other individual cost-based alternative as "direct cost of signals plus nominal contribution to joint and common costs." Notice at para. 53. Under this alternative "reasonable rates" would be based on the direct costs of basic programming plus, in recognition of the requirements in Section 623(b)(2)(C), a "nominal" contribution to the joint and common costs of the system as a whole. Muzak generally supports this proposal as a potentially effective and efficient method of ensuring reasonable rates and preventing cross-subsidation. As the Commission notes, the accounting requirements are simple and should be easy to administer. Notice at note 84. However, the Notice (at para. 55) suggests that the Commission would consider a number of different options for the treatment of joint and common costs, including methods that "would recover far less than the fully distributed cost of providing [basic] service." While Muzak understands that policy preferences can and typically should enter into cost allocation methods, the legislative history of the Act clearly demonstrates Congress' intent that the Commission use a "fully allocated" cost methodology.[9]

While Muzak generally would support policy judgements that would lower the rates paid for basic cable service, it cannot support allowing regulators the discretion to allow services to recover less or more than their fully allocated costs. Such discretion could result in allocation of costs from unregulated audio and other non-traditional services to regulated basic services, a result which would legitimize unfair cross-subsidization that not only contributes to unreasonable rates for basic service, it undercuts competition. Specifically, if cable operators can pass off to basic service rate payers, the proportion of joint costs properly allocable to unregulated services, it can use marginal pricing for those unregulated services, while its competitors must recover all of their costs in pricing similar services. Such a result was forbidden by Congress, which stated that under the requirements of Section 623(b)(2)(C)(iii), costs allocated to rates for basic services "must not be permitted to

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[9] See House Report at 83: "In effect, this provision requires a 'fully allocated' costing methodology across all cable services."

serve as the base that allows for marginal pricing of unregulated services."[10]

Thus, Muzak supports much of the "direct cost of signals plus nominal contribution to joint and common costs" regulatory alternative. However, it is clear that if the term "nominal" refers to the possibility that the Commission would enact regulations where joint and common costs of regulated and unregulated are not fully allocated, such a proposal is not only bad policy, it is clearly contrary to the legislative intent of the Act. In any case, cost allocation rules must take into account audio services, especially those offered to non-residential customers, and make sure that costs associated with those services are not assigned to residential video services.

III. The Regulation of "Cable Programming Services"

The 1992 Cable Act amends Section 623(c) of the Communications Act to require the Commission to establish criteria for identifying, in individual cases, unreasonable charges for "cable programming services." One of the factors that Section 623(c) states the Commission shall consider is "capital and operating costs of the cable system." The Commission recognizes that the regulatory alternatives discussed in connection with the regulation of basic services should generally apply to the regulation of cable programming services. Notice at para. 92. However, the Commission asserts that the "direct cost of signals, nominal contribution to joint and common costs" approach is not appropriated to tiers other

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[10] See H.R. Rep. No. 862, 102d Cong., 2d Sess., at 63 (1992)(hereinafter the "Conference Report"). See also the House Report at 83 ("The regulated tier cannot be permitted to serve as a base that allows for marginal pricing of unregulated services.")

than basic service. Notice at note 128. The explanation given for this distinction is that either (1) contribution to basic costs from higher tiers would threaten the viability of pay-per-view programming or (2) contribution to higher tiers from basic service costs would raise the cost of basic service too high. The flaw in this argument was pointed out in the above discussion of this regulatory method as applied to basic rates: i.e., regardless of Commission policy preferences, it was the clear intent of Congress that the Commission use fully allocated cost methods in its rate regulations.[11] Using the fully allocated cost methodology, there would be no discretion for regulators to choose whether to subsidize basic rates with higher tier revenue or vice versa: rates for each tier would cover their respective proportions of joint and common costs. Accordingly, for the reasons stated above, for regulation of the rates for cable programming services, Muzak supports use of either of the individual system cost-based methods, or the "typical cost-of-service" benchmark.

IV. The Need For Separate Subsidiaries

While Muzak believes that use of some the regulatory methods discussed above may help ensure that reasonable rates are offered to subscribers, it is concerned none of these methods, including the individual system COS approach, will be sufficient to prevent cross-subsidization between regulated and non-regulated services without an additional requirement that cable systems establish a separate subsidiary, with separate books, to operate non-regulated services. If the Commission is to take seriously its task of

[11] See note 9, supra. The House Report (at 83) states that fully allocated costing methodology was contemplated "across all cable services." (emphasis added).

ensuring reasonable rates, it must address and attempt to remedy this cross-subsidization problem.[12]

The Commission has long recognized that the subsidization of unregulated services from regulated services leads to unreasonable rates paid by subscribers of those regulated services.[13] There are at least two potential types of cross-subsidation between regulated cable video services and unregulated cable audio services, i.e., where:

1. the common costs of the audio and video services are improperly allocated; and where

2. the separate costs of the audio service are subsidized with revenue from the video service.

It is not clear that the cost allocation methods proposed by the Commission are sufficient to prevent the first type of cross-subsidation, in the absence of some sort of separate subsidiary requirement wherein different subsidiaries of the same company would be required to keep separate books. While the Commission has recognized this in the past, it has more recently sought to rely on "non-structural safeguards."[14] It is unclear, at best, if

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[12] In establishing its rate regulation methodology, the Commission must remain cognizant of the changes occurring in the cable services business, including the actual and intended growth in the provision of "non-traditional" audio, video and data services by cable operators. In is incumbent on the Commission to now establish a rate regulation system that will account for the cost impact of these new services.

[13] See note 4, supra. Congress' concern regarding cross-subsidation of unregulated services is demonstrated in the House Report at 83 ("The regulated tier cannot be permitted to serve as a base that allows for marginal pricing of unregulated services.")

[14] Thus, in structuring the provision of non-regulated services by regulated common carriers, the Commission at one point recognized that cost-allocation manuals were insufficient to prevent cross-subsidation between regulated and non-regulated

substitutes for separate subsidiary requirements, such as revised cost-allocation manuals, have been effective in preventing cross-subsidation by phone companies. And while the proposals in this proceeding attempt to regulate the misallocation of common costs (example 1, above), they do not seem to even address the case where revenues from regulated services subsidize the costs of the other (example 2, above). Prevention of this abuse would also seem to require some sort of separate subsidiary requirement, wherein transactions between the two subsidiaries would be substantially regulated and scrutinized.[15]

V. Conclusion

In light of the importance placed by Congress on protecting consumers from unreasonable rates for cable service, the Commission's regulations must address and prevent improper shifting of joint and common costs from unregulated audio services to regulated video services. Use of the "typical" cost-of-service benchmark approach, or of either of the suggested individual system cost-based alternatives, is mandated if the Commission is to fulfill the requirements Congress placed in Section 623(b)(2)(C)(iii) of the Communications Act. However, regardless of the chosen rate regulation methodology, an additional separate subsidiary

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subsidiaries, and instituted a separate subsidiary requirement. Second Computer Inquiry, Final Order, 77 FCC 2d 384, 464 (1980). However, a few years later the Commission abandoned the separate subsidiary requirement and replaced it with supposedly more effective joint accounting manuals. Third Computer Inquiry, 104 FCC 2d 958 (1986). The Ninth Circuit found that the Commission failed to explain or justify this change in policy, and reversed and remanded in California v. FCC, 905 F.2d 1217 (1990).

[15] See, e.g., Section 32.23 and 32.27 of the Commission's Rules. Cf. New York Telephone Co., 5 FCC Rcd 866,867 (1990).

requirement may be necessary to fully prevent improper cross-subsidization.

Respectfully submitted,

MUZAK LIMITED PARTNERSHIP

By: Paul J Feldman

Edward W. Hummers, Jr.
Paul J. Feldman

Its Attorneys

Current address
FLETCHER, HEALD, & HILDRETH
1225 Connecticut Ave. N.W.
Washington, D.C. 20036
(202) 828-5700

Address effective February 1, 1993

Fletcher, Heald & Hildreth
11th Floor
1300 North 17th Street
Rosslyn, VA 22209
(703) 812-0400

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